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THE EXCLUDABILITY OF DAMAGES FOR PERSONAL INJURY AFTER THE SUPREME COURT'S DECISION IN BURKE

by

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INTRODUCTION

The scope of the personal injury exclusion under Internal Revenue Code § 104(a)(2) has been significantly broadened since the mid-1980's as the result of numerous court decisions in the areas of reputation and discrimination injuries.¹ In our increasingly litigious society, more tax cases contesting the excludability of damages recoveries are expected. In *United States v. Burke*, decided May 26, 1992, the Supreme Court resolved an important issue regarding excludability from federal taxation of damages received in discrimination cases.² Unfortunately, the case was decided on narrow grounds, which may only add to, rather than reduce, the conflict among the lower courts.³ *Burke*, which involves the exclusion of recoveries under Title VII for sex discrimination, is discussed below.⁴

Tax professionals need to be aware of the tax implications of personal injury recoveries in order to help clients and clients' legal advisors plan strategy prior to the initiation of actions for damage recoveries and to properly report amounts received. This article reviews *Burke* and other recent developments in the areas of (1) taxation of recoveries for injury to reputation, (2) taxation of recoveries for discrimination, and (3) taxation of punitive damages received in personal injury suits. This article concludes with a discussion of tax planning implications of these issues and new developments.

Section 61(a) of the Internal Revenue Code provides that "gross income means all income from whatever source derived."⁵ An exception to the all inclusive rule of § 61(a) is found in § 104(a)(2), which excludes "the amount of any damages received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal injuries or sickness."⁶ Amendments to § 104(a)(2) by the 1989 Revenue Reconciliation Act (RRA) relating to the treatment of punitive damages are discussed later in this article.

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¹ See *United States v. Burke*, 112 S.Ct. 1867, 1871 n.6 (1992).

² See *id.* at 1868.

³ *Id.* at 1874.

⁴ *Id.* at 1868.

⁵ I.R.C. § 61(a) (1992).

⁶ I.R.C. § 104(a)(2) (1992).

Treatment of Damages for Injury to Reputation

Damages for injury to reputation have been held to be excludable under § 104(a)(2).⁷ However, it is the position of the IRS that damages awarded for injury to the taxpayer's business or professional reputation are not based on personal injury and therefore are not excludable under § 104(a)(2).⁸ Three cases, *Roemer v. Commissioner*,⁹ *Threlkeld v. Commissioner*,¹⁰ and *Miller v. Commissioner*,¹¹ illustrate the positions of the IRS and the courts regarding exclusion of damages for injury to business or professional reputation.

In *Roemer*, the taxpayer sought to exclude under § 104(a)(2) an award of compensatory and punitive damages for injury to his personal and business reputation.¹² Roemer requested a credit report in connection with an application for an agency license with an insurance company.¹³ The credit agency issued a defamatory report which questioned Roemer's honesty and the integrity of his business dealings.¹⁴ Roemer was denied the agency license that he sought and suffered harm to his reputation in the community.¹⁵ Roemer then brought an action for libel under the California Civil Code and was awarded compensatory damages of \$40,000 and punitive damages of \$250,000.¹⁶ The award did not allocate damages according to Roemer's personal injury or his economic losses.¹⁷ In his complaint, Roemer emphasized the damage to his business relationships.¹⁸ The IRS argued that the damages were awarded primarily to compensate the taxpayer for lost income and, therefore, compensated him for damages to his business and professional reputation rather than his personal reputation.¹⁹ The IRS concluded that these damages were not due to personal injuries and were not excludable under § 104(a)(2).²⁰ The Tax Court held that a distinction should be made between injury to personal reputation and injury to business or professional reputation because the latter are not excludable under § 104(a)(2).²¹ The Tax Court agreed with the IRS and held that the damages received by Roemer were primarily for injury to his business and professional reputation and

⁷ See *Burke*, 112 S. Ct. at 1871 n.6.

⁸ See *Roemer v. Commissioner*, 716 F.2d 693 (9th Cir. 1983).

⁹ *Id.*

¹⁰ *Threlkeld v. Commissioner*, 848 F.2d 81 (6th Cir. 1988).

¹¹ *Miller v. Commissioner*, 914 F.2d 586 (4th Cir. 1990).

¹² *Roemer*, 716 F.2d at 695.

¹³ *Id.* at 694-95.

¹⁴ *Id.* at 695.

¹⁵ *Id.*

¹⁶ *Id.*

¹⁷ *Id.*

¹⁸ *Id.*

¹⁹ *Id.*

²⁰ *Id.*

²¹ *Id.* at 406-07.

were not on account of personal injury.²² Because the damages were not on account of a personal injury, the Tax Court decided that the § 104(a)(2) exclusion was not available.²³

In 1983, the Ninth Circuit reversed the Tax Court's decision in *Roemer* and refused to draw a distinction between injury to personal reputation and injury to professional reputation for purposes of § 104(a)(2).²⁴ The Ninth Circuit held that the nature of the tort of defamation, as defined by state law, must be examined to determine whether the injuries are personal.²⁵ The court stated that if defamation is a personal injury, then compensatory damages flowing therefrom, including economic damages, are excludable.²⁶ In addressing these points, the court stated:

... all defamatory statements attack an individual's good name. This injury to the person should not be confused with the derivative consequences of the defamatory attack, i.e., the loss of reputation in the community and any loss of income. The nonpersonal consequences of personal injury, such as a loss of future income, are often the most persuasive means of proving the extent of the injury that was suffered. The personal nature of an injury should not be defined by its effect.²⁷

The Ninth Circuit found that defamation of an individual is a personal injury under California state law.²⁸ Thus, the taxpayer's damages were recovered on account of personal injury and were excludable under § 104(a)(2).²⁹

In 1986 the Tax Court reversed its position in *Roemer* and adopted the Ninth Circuit's decision in *Roemer*.³⁰ This reversal occurred in *Threlkeld v. Commissioner* where the taxpayer sought to exclude a settlement recovery for malicious prosecution.³¹ Threlkeld settled an action for malicious prosecution and recovered damages of \$300,000, including \$75,000 specifically allocated to damages for injury to professional reputation.³² The IRS argued that damages resulting from injury to the taxpayer's professional reputation were taxable.³³ However, the Tax Court agreed that no distinction should be drawn

²² *Id.* at 406.

²³ *Id.* at 407.

²⁴ *Roemer*, 716 F.2d 693, 700-01 (9th Cir. 1983).

²⁵ *Id.* at 697.

²⁶ *Id.*

²⁷ *Id.* at 699.

²⁸ *Id.* at 700.

²⁹ *Id.*

³⁰ See *Threlkeld v. Commissioner*, 848 F.2d 81, 83 (6th Cir. 1988).

³¹ *Id.*

³² *Id.* at 82.

³³ *Id.*

between injury to personal reputation and injury to professional reputation.³⁴ After considering the nature of the claim and state law characterization of an action for malicious prosecution, the Tax Court determined that the damages were received on account of personal injuries.³⁵ The fact that a portion of the damages was specifically allocated to injury to professional reputation was not relevant in the decision.³⁶ The Tax Court reviewed all of the facts and circumstances, not simply state law, to determine whether the injury was personal.³⁷ *Threlkeld* was affirmed by the Sixth Circuit which adopted the reasoning in *Roemer*.³⁸

In 1989 the Tax Court had an opportunity to reconsider its position in *Threlkeld*.³⁹ In *Miller v. Commissioner*, the taxpayer received a settlement for damages resulting from defamation.⁴⁰ The taxpayer had been accused of embezzlement by her employer and had been fired.⁴¹ The taxpayer prevailed in a suit for damages against her employer and subsequently settled for an amount which was not allocated between compensatory and punitive damages.⁴² The IRS stated that the settlement proceeds represented a recovery for damage to professional reputation and, thus, were not excludable from gross income.⁴³ As in *Threlkeld*, the Tax Court refused to "draw a distinction between damage to personal reputation and damage to professional reputation."⁴⁴ The Tax Court held that under Maryland state law, an action for defamation was personal in nature.⁴⁵ Thus, all damages, compensatory and punitive, received on account of defamation were excludable under § 104(a)(2).⁴⁶ On appeal the Fourth Circuit overruled the Tax Court regarding the punitive damages.⁴⁷ A discussion of punitive damages appears later in this article. The IRS did not appeal the Tax Court's holding regarding the compensatory damages.

Roemer, *Threlkeld*, and *Miller* illustrate the position of the IRS in defamation actions in which damages flowing therefrom can be related to the taxpayer's income, business, profession, or employment. Recently the IRS has not been successful in arguing that economic losses recovered in defamation suits are not excludable. However, the IRS has not changed its position. The exclusion of economic damages is a prominent issue in the discrimination cases analyzed next.

³⁴ *Id.*

³⁵ *Id.*

³⁶ *Threlkeld v. Commissioner*, 87 T.C. 1294, 1307 (1986), *aff'd*, 848 F.2d 81 (6th Cir. 1988).

³⁷ *Id.* at 1308.

³⁸ *Threlkeld*, 848 F.2d at 84.

³⁹ See *Miller v. Commissioner*, 93 T.C. 330, 337 (1989), *rev'd*, 914 F.2d 586 (4th Cir. 1990).

⁴⁰ *Id.* at 333-34.

⁴¹ *Id.* at 331-32.

⁴² *Id.* at 333-34.

⁴³ *Id.* at 335.

⁴⁴ *Id.* at 337.

⁴⁵ *Id.* at 335.

⁴⁶ *Id.* at 337-41.

⁴⁷ *Miller*, 914 F.2d 586, 592 (4th Cir. 1990), *rev'g* 93 T.C. 330 (1989).

Treatment of Discrimination Recoveries

The scope of excludable damages under § 104(a)(2) includes damages based upon common law torts such as libel, slander, malicious prosecution, wrongful death, etc., and damages based upon "tort-type" rights.⁴⁸ The regulations do not define tort-type rights. Courts have held that recoveries based upon age, sex, and race discrimination are within the scope of § 104(a)(2).

1. Sex Discrimination

In *United States v. Burke* numerous plaintiffs received settlements for back wages due to sex discrimination.⁴⁹ Burke and other employees of the Tennessee Valley Authority (TVA) filed a lawsuit against the TVA under Title VII of the Civil Rights Act of 1964 for discrimination in pay against female employees.⁵⁰ The case was settled and the TVA agreed to distribute \$5,000,000, net of income and FICA taxes, to the affected employees.⁵¹ The payment to each employee was based on length of service and rate of pay for the period of discrimination.⁵² The settlement agreement provided for no payments other than back pay.⁵³

The District Court found that all payments were in lieu of back pay and held that such payments were not damages on account of personal injury and were not excludable under § 104(a)(2).⁵⁴ The Sixth Circuit Court overruled the District Court in *Burke* and held that all payments for back pay received in the sex discrimination action were excludable.⁵⁵ The court held that the appropriate test for determining excludability was the nature of the injury rather than the derivative consequences of the injury such as loss of wages.⁵⁶ Once the court determined that sex discrimination was a tort-like injury, the excludability issue was settled.⁵⁷

The IRS appealed *Burke* to the Supreme Court, which decided the case in May 1992.⁵⁸ *Burke* was decided on narrow grounds and may have limited applicability. Since recent amendments to Title VII are significant in *Burke*, these amendments are briefly discussed.

⁴⁸ I.R.C. § 104(a)(2) (1992).

⁴⁹ *United States v. Burke*, 112 S. Ct. 1867, 1869 (1992).

⁵⁰ *Id.* at 1868-69.

⁵¹ *Id.* at 1869.

⁵² *Id.*

⁵³ *Id.*

⁵⁴ *Id.*

⁵⁵ *Id.* at 1869-70.

⁵⁶ *United States v. Burke*, 929 F.2d 1119, 1121 (6th Cir. 1990), *rev'd*, 112 S. Ct. 1867 (1992).

⁵⁷ *Id.*

⁵⁸ *Burke*, 112 S. Ct. at 1867.

Prior to the enactment of the Civil Rights Act of 1991 (CRA 1991) the only monetary remedy under Title VII was back pay. Title VII did not provide for payment of compensatory or punitive damages for other injuries such as pain and suffering, emotional distress, or harm to reputation.⁵⁹ CRA 1991 amended Title VII to allow victims of intentional discrimination to receive awards for compensatory and punitive damages.⁶⁰ By enacting these amendments Congress sought to compensate victims for injury to "their careers, mental and emotional health, and to their self-respect and dignity."⁶¹ Title VII as amended by CRA 1991 provides for payment of compensatory and punitive damages which have traditionally been associated with torts, in addition to back pay.⁶² Title VII, prior to amendment by CRA 1991, is referred to below as the "pre-1991 Title VII," while Title VII, as amended by the CRA 1991, is referred to as "amended Title VII."

The Supreme Court in *Burke* examined the nature of the remedies afforded by Title VII to victims of sex discrimination in order to determine if the payment of back pay fell within the exclusion of damages received on account of personal injuries or sickness.⁶³ The Court stated "... we believe that consideration of the remedies available under Title VII is critical in determining the 'nature of the statute' and the 'type of claim' brought by respondents for purposes of [§] 104(a)(2)."⁶⁴ The Court agreed that discrimination on the basis of sex could be an invasion of an individual right that is properly classified as a tort.⁶⁵ The Court stated: "no doubt discrimination could constitute a 'personal injury' for purposes of § 104(a)(2) if the relevant cause of action evidenced a tort-like conception of injury and remedy."⁶⁶ The Court then looked at the remedies provided by Title VII to determine whether Title VII "redresses a tort-like personal injury."⁶⁷ The Court concluded that pre-1991 Title VII did not redress a tort-like personal injury because it did not provide for compensatory or punitive damages traditionally allowed under tort law.⁶⁸ The Court emphasized that Title VII's "sole remedial focus" on back pay was insufficient to bring it within the scope of traditional tort damages.⁶⁹

⁵⁹ *Id.* at 1874 n.12.

⁶⁰ *Id.*

⁶¹ *Id.*

⁶² *Id.*

⁶³ *See id.* at 1872.

⁶⁴ *Id.* at 1872 n.7.

⁶⁵ *Id.* at 1873.

⁶⁶ *Id.*

⁶⁷ *Id.* at 1874.

⁶⁸ *Id.*

⁶⁹ *Id.*

Does the ruling in *Burke* have implications for other discrimination cases or is it a narrow ruling with implications only for awards granted under the pre-1991 Title VII? The *Burke* Court stated

... we believe that Congress' decision to permit jury trials and compensatory and punitive damages under the amended act signals a marked change in its conception of the injury redressable by Title VII, and cannot be imported back into the analysis of the statute as it existed at the time of this lawsuit.⁷⁰

Would the Court's ruling have been different if *Burke* had recovered under amended Title VII? The above quotation suggests that a different result might be reached under amended Title VII. The Court suggests that the "marked change in the conception of the injury" transforms amended Title VII into a tort-like remedy.⁷¹

However, the possibility exists that the Supreme Court might treat recoveries under the amended Title VII as follows: (1) back pay claims might be viewed as contractual in nature and thus not excludable, while (2) compensatory damages might be held excludable as tort-like damages. Footnote thirteen in *Burke* suggests the above dichotomy.⁷² The Court stated that "Our holding that damages received in settlement of a Title VII award are not properly excludable under § 104(a)(2) finds support in longstanding rulings of the IRS,"⁷³ citing *Revenue Ruling 72-341*.⁷⁴ In RR 72-341 the IRS ruled that payments received by employees of a corporation as a result of a suit under Title VII are compensation and are includable in gross income.⁷⁵ The above comments are obviously speculative because they are based on dicta. The Supreme Court was not faced with the issue of excludability of awards under amended Title VII and, based on long standing tradition, chose not to address that issue.⁷⁶

In *Metzger v. Commissioner*, decided in 1987, the Tax Court considered the excludability of a recovery for sex discrimination based on Title VII and several other causes of action.⁷⁷ Metzger sued her college employer when she was denied tenure.⁷⁸ Several suits were filed based on claims of breach of contract and discrimination on account of sex and national origin.⁷⁹ An agreement was reached in which Metzger accepted \$75,000

⁷⁰ *Id.* at 1874 n.12.

⁷¹ *Id.*

⁷² *See id.* at 1874 n.13.

⁷³ *Id.*

⁷⁴ Rev. Rul. 72-341, 1972-2 C.B. 32.

⁷⁵ *Id.*

⁷⁶ *Burke*, 112 S.Ct. at 1872 n.8.

⁷⁷ *Metzger v. Commissioner*, 88 T.C. 834 (1987), *aff'd*, 845 F.2d 1013 (3d Cir. 1988).

⁷⁸ *Id.* at 838.

⁷⁹ *Id.* at 839-40.

in settlement of all claims.⁸⁰ The settlement stated that \$37,500 was in settlement of wage claims and \$37,500 was in settlement of all other claims, which included damages for personal injuries, punitive damages, and attorney's fees.⁸¹ Metzger reported the wage claim settlement as gross income and claimed an exclusion for the \$37,500 paid in settlement of all other claims.⁸² The IRS argued that the entire settlement was includable in gross income.⁸³

The Tax Court reviewed several claims brought by Metzger including claims (1) under 42 U.S.C. §§ 1981, 1982, 1985, and 1986; (2) under the thirteenth and fourteenth amendments to the U.S. Constitution; and (3) under similar state statutes.⁸⁴ The Tax Court reviewed several cases which described the above actions as (1) personal injury actions (2) resulting in tort liability (3) for which damages are allowable and (4) which are subject to personal injury statutes of limitations.⁸⁵ The court concluded that most of Metzger's claims were for personal injuries based on tort claims rather than for back pay.⁸⁶ The court held that at least \$37,500 of the recovery was excludable and suggested that a greater exclusion would have been allowed had Metzger sought to exclude more than \$37,500.⁸⁷ However, the Tax Court affirmed its prior holding in *Hodge* that a recovery under Title VII, solely for back pay, is not excludable.⁸⁸

Metzger provides the following important rulings which may be applicable after *Burke*: (1) where discrimination claims are based solely on Title VII and calculated solely on the basis of back pay, the recovery is not excludable, and (2) where other causes of action for discrimination are raised which provide for damage remedies, recoveries are excludable even if based in part on lost earnings.⁸⁹ This result would follow when lost earnings serve as evidence of the amount of the injury rather than an independent basis for recovery under the cause of action. *Metzger* was affirmed by the Third Circuit Court of Appeals without a published opinion.⁹⁰

An additional issue of interest was raised in *Metzger* concerning the validity of a claim or cause of action.⁹¹ The IRS argued that none of the damages could be personal

⁸⁰ *Id.* at 842.

⁸¹ *Id.*

⁸² *Id.* at 845.

⁸³ *Id.* at 846.

⁸⁴ *Id.* at 845.

⁸⁵ *Id.* at 847-58.

⁸⁶ *Id.* at 858.

⁸⁷ *Id.*

⁸⁸ *Id.* See also *Hodge v. Commissioner*, 64 T.C. 616 (1975).

⁸⁹ See *Metzger*, 88 T.C. at 834.

⁹⁰ *Metzger v. Commissioner*, 845 F.2d 1013 (3rd Cir. 1988).

⁹¹ *Metzger*, 88 T.C. at 851-52.

since the statute of limitations on a personal injury case ran before Metzger filed suit.⁹² The Tax Court held that, even if the statute of limitations had run, the nature of the claim, not the validity, determined excludability under § 104(a)(2).⁹³

In *Thompson v. Commissioner* the taxpayer received back pay and liquidated damages in a sex discrimination suit brought under the Equal Pay Act (EPA) and Title VII.⁹⁴ As a general rule, the EPA prohibits discrimination based upon sex with respect to compensation for equal work.⁹⁵ The EPA provides for payment of (1) back pay and (2) liquidated damages equal to the back pay.⁹⁶ Liquidated damages can be avoided by an employer upon a showing of good faith.⁹⁷ Employees cannot obtain a double recovery under both the EPA and Title VII for back pay.⁹⁸ The Tax Court held that damages for back pay under the EPA were received on account of a contract-type claim and were not excludable under § 104(a)(2).⁹⁹ Then, the court analyzed the nature of liquidated damages and found that the fact that liquidated damages were paid provides evidence that the employer did not act in good faith and that Thompson was personally injured.¹⁰⁰ Therefore, the liquidated damages were received on account of the sex discrimination claim and were excludable.¹⁰¹

On appeal, the Fourth Circuit accepted the reasoning of the Tax Court.¹⁰² The court held that "... sex discrimination actions in general are tort or tort-type actions and damages awarded for violation of that right are damages for personal injuries."¹⁰³ The court then looked at the elements of the recovery and the nature of each claim to determine the tax consequences.¹⁰⁴ The court found that back pay was essentially an award for a contract violation whereas liquidated damages were awarded to compensate the employee for obscure damages difficult to measure.¹⁰⁵ Based upon the nature of the awards, the Circuit Court held that: (1) back pay was not excludable and (2) liquidated damages were excludable as damages received on account of a personal injury.¹⁰⁶

⁹² See *id.* at 852-55.

⁹³ *Id.* at 858.

⁹⁴ *Thompson v. Commissioner*, 866 F.2d 709-710 (4th Cir. 1989).

⁹⁵ See *id.* at 711.

⁹⁶ *Id.* at 711-12.

⁹⁷ *Id.* at 712.

⁹⁸ *Id.* at 711-12.

⁹⁹ *Id.* at 712.

¹⁰⁰ *Thompson v. Commissioner*, 89 T.C. 632 (1987), *aff'd*, 866 F.2d 709 (4th Cir. 1989).

¹⁰¹ *Id.* at 650.

¹⁰² *Thompson*, 866 F.2d at 712.

¹⁰³ *Id.*

¹⁰⁴ *Id.*

¹⁰⁵ *Id.*

¹⁰⁶ *Id.*

As suggested in the discussion of *Burke* earlier, the above contract/tort dichotomy may be applied in sex discrimination cases after *Burke*. This dichotomy is an important issue in the following discussion of age discrimination cases.

2. Age Discrimination

The Age Discrimination in Employment Act (ADEA) prohibits discrimination in hiring, promotion, and termination on account of age and applies to employees between the ages of forty and seventy.¹⁰⁷ Remedies provided by the ADEA include: (1) recovery of back pay, (2) recovery of liquidated damages equal to back pay where violations by the employer are willful, and (3) other equitable relief including reinstatement, promotion, or hiring.¹⁰⁸

The first case before the Tax Court to contest the excludability of age discrimination recoveries was *Rickel v. Commissioner*.¹⁰⁹ Rickel was sales manager for MM Company, whose president told him that someone younger was wanted for the sales manager's position.¹¹⁰ Shortly thereafter Rickel was removed from his position, his pay was reduced, and later, he was discharged.¹¹¹ Rickel brought suit under the ADEA against his former employer for unlawful discharge.¹¹² In his complaint he requested back pay, liquidated damages equal to back pay, attorney fees, and reinstatement.¹¹³ A settlement was reached which did not allocate the monetary recovery to either back pay, liquidated damages, or attorney fees.¹¹⁴ The Tax Court reviewed the ADEA and determined that it provided for recoveries based on contract and tort claims.¹¹⁵ The Tax Court held (1) that wage-related claims were based on breach of contract elements and were not excludable from gross income, and (2) that liquidated damages were intended to compensate the plaintiff for hard to measure damages resulting from a tort-type injury and were therefore, excludable from gross income under § 104(a)(2).¹¹⁶ Since the ADEA provides for liquidated damages equal to back pay, the Tax Court held that the recovery should be allocated equally between liquidated damages and back pay.¹¹⁷

In *Wirtz v. Commissioner* the taxpayer filed several age discrimination suits under the ADEA and requested that the District Court award back pay, liquidated damages, and

¹⁰⁷ See 29 U.S.C. § 623 (1) (1992) (prohibitions); 29 U.S.C. § 631(a) (1992) (age).

¹⁰⁸ See 29 U.S.C. § 626 (1992).

¹⁰⁹ *Rickel v. Commissioner*, 92 T.C. 510 (1989), *aff'd in part, rev'd in part*, 900 F.2d 655 (3d Cir. 1990).

¹¹⁰ *Rickel v. Commissioner*, 900 F.2d 655 (3d Cir. 1990).

¹¹¹ *Id.*

¹¹² *Id.*

¹¹³ *Id.* at 657.

¹¹⁴ *Id.*

¹¹⁵ *Rickel v. Commissioner*, 92 T.C. 510, 522 (1989), *aff'd in part, rev'd in part*, 900 F.2d 655 (3d Cir. 1990).

¹¹⁶ *Id.*

¹¹⁷ *Id.*

reinstatement.¹¹⁸ No liquidated damages were awarded because the District Court found that the employer violations were not willful.¹¹⁹ Back pay was awarded as well as front pay in lieu of reinstatement.¹²⁰ The Tax Court held that neither of the recoveries were intended to compensate the plaintiff for tort-type claims and that both recoveries were in lieu of lost wages.¹²¹ Following *Rickel*, the Tax Court held that the recoveries were not excludable.¹²²

In *Pistillo v. Commissioner* the taxpayer brought an age discrimination suit under the ADEA and was awarded compensatory (wage-related) damages by the jury.¹²³ No liquidated damages were awarded.¹²⁴ A subsequently entered settlement agreement did not specify whether the payments received were intended to cover wage related claims or liquidated damages.¹²⁵ The Tax Court cited *Rickel* with approval and held that “the compensatory [wage-related] damage component is in the nature of a payment for a contractual violation rather than a tort-type right.” The court then held that the total payment was includable in gross income.¹²⁶

Both *Rickel* and *Pistillo* were overruled in 1990 by the Third and Sixth Circuit Courts, respectively.¹²⁷ In *Rickel* the Third Circuit cited with approval *Threlkeld* and *Roemer* which held that the focus of the exclusion inquiry should be the personal or nonpersonal nature of the claim and not the derivative consequences of the defendant’s actions such as loss of income.¹²⁸ The court stated that “. . . once it [the Tax Court] found that age discrimination was analogous to a personal injury and that the taxpayer’s ADEA action amounted to a tort-type right, the Tax Court should have ended its analysis and found that all damages flowing therefrom were excludable under § 104(a)(2).”¹²⁹ The Circuit Court characterized an age discrimination claim as a tort-type right and held that both the wage-related damages and the liquidated damages paid on account of such a claim were excludable under § 104(a)(2).¹³⁰ Similarly, in *Pistillo* the Sixth Circuit reversed the Tax Court decision and held that the age discrimination suit was a tort-type action and that the economic damages flowing therefrom (back pay) did not create a

¹¹⁸ *Wirtz v. Commissioner*, 56 T.C.M. (CCH) 1596 (1989).

¹¹⁹ *Id.*

¹²⁰ *Id.*

¹²¹ *Id.* at 1598.

¹²² *Id.*

¹²³ *Pistillo v. Commissioner*, 57 T.C.M. (CCH) 874, 875 (1989), *rev’d*, 912 F.2d 145 (6th Cir. 1990).

¹²⁴ *Id.* at 877.

¹²⁵ *Id.* at 879.

¹²⁶ *Id.*

¹²⁷ See *Rickel v. Commissioner*, 900 F.2d 655, 656-57 (3rd Cir. 1990); *Pistillo v. Commissioner*, 912 F.2d 142, 150 (6th Cir. 1990).

¹²⁸ See *Rickel*, 900 F.2d at 661.

¹²⁹ *Id.*

¹³⁰ *Id.* at 663-64.

nonpersonal injury.¹³¹ The Sixth Circuit employed the same reasoning used by the Third Circuit in *Rickel*, and held that damages recovered by Pistillo were excludable under § 104(a)(2).¹³²

Soon after *Rickel* and *Pistillo* were overruled, the Tax Court had another opportunity to reconsider its position regarding age discrimination recoveries. In *Downey v. Commissioner* decided in 1991, the Tax Court overruled its prior decisions in *Rickel* and *Pistillo*.¹³³ Downey, a pilot for United Airlines, was involuntarily retired by his employer at age sixty.¹³⁴ He filed an age discrimination suit under the ADEA and sought reinstatement, back pay, and liquidated damages.¹³⁵ The case was settled and Downey agreed to drop all claims.¹³⁶ The settlement agreement allocated \$60,000 to non-liquidated (wage-related) damages and \$60,000 to liquidated damages.¹³⁷ The settlement agreement provided that the \$60,000 allocated to wage-related payments was subject to payroll taxes and withholding.¹³⁸ The IRS argued that wage-related payments were taxable because they were paid in settlement of a claim for back pay rather than a claim for personal injury.¹³⁹ The IRS also argued that liquidated damages under the ADEA are intended to punish the employer and, thus, are taxable as punitive damages.¹⁴⁰

The Tax Court reviewed the history of § 104(a)(2) and concluded that the focus of the exclusion issue is the nature of the claim and whether the injury is personal, not the consequences of the injury such as loss of income.¹⁴¹ Applying this principle, the Tax Court found that age discrimination is a violation of a tort-type right and that damages paid on account of age discrimination are excludable even though based on lost wages.¹⁴² The Tax Court also held that liquidated damages under the ADEA were intended by Congress, and had been interpreted by the courts, as compensatory damages to the plaintiff even though the employer viewed such damages as punitive.¹⁴³ Thus, liquidated damages were paid "on account of" the personal injury suffered by Downey and were excludable under § 104(a)(2).¹⁴⁴ The situation in *Keller v. Commissioner*

¹³¹ *Pistillo*, 912 F.2d at 149-50.

¹³² *Id.* at 150.

¹³³ See *Downey v. Commissioner*, 97 T.C. 150,168 (1991).

¹³⁴ *Id.* at 153-54.

¹³⁵ *Id.* at 154.

¹³⁶ *Id.* at 155.

¹³⁷ *Id.*

¹³⁸ *Id.*

¹³⁹ *Id.* at 156.

¹⁴⁰ *Id.* at 157.

¹⁴¹ *Id.* at 157-64.

¹⁴² *Id.* at 169-70.

¹⁴³ *Id.* at 173.

¹⁴⁴ *Id.*

parallels the factual situation in *Downey*.¹⁴⁵ Keller sought to exclude back pay and liquidated damages received under an ADEA claim.¹⁴⁶ The Tax Court refused to overrule *Downey* and held that all of the damages received by Keller were excludable.¹⁴⁷

In *Redfield v. Insurance Co. of North America* (ICNA), the Ninth Circuit Court noted its agreement with *Pistillo* and *Rickel* and held that "economic damages" received under an ADEA claim were excludable under § 104(a)(2) and were not subject to federal income tax withholding.¹⁴⁸ Redfield sued ICNA under the ADEA and other statutory and tort actions.¹⁴⁹ The jury awarded an amount described as "economic damages."¹⁵⁰ ICNA paid the judgment amount less federal and state income taxes and FICA taxes.¹⁵¹

In *Redfield* the Circuit Court was called on to determine whether ICNA properly deducted state and federal taxes from the judgment amount.¹⁵² Redfield argued that the judgment against ICNA was not satisfied until ICNA paid the full amount undiminished by tax withholding.¹⁵³ The Circuit Court noted that the Third Circuit in *Rickel* and the Sixth Circuit in *Pistillo* had previously held that damages received under ADEA claims are excludable under § 104(a)(2).¹⁵⁴ The Circuit Court found that the economic damages received by Redfield arose from his ADEA claims.¹⁵⁵ The court agreed with the Third and Sixth Circuits and held that recoveries under the ADEA are excludable under § 104(a)(2).¹⁵⁶

Even though the IRS was not a litigant in *Redfield*, the case presents clearly the position of the Ninth Circuit.¹⁵⁷ Based on the Tax Court's decision in *Downey* and the opinions of the Third, Sixth, and Ninth Circuits, there is a significant weight of authority that all damages paid in age discrimination suits under the ADEA are excludable from gross income.

3. Race Discrimination

In *Sparrow v. Commissioner*, the plaintiff sued the Navy for racial discrimination under Title VII of the Civil Rights Act of 1964.¹⁵⁸ Sparrow was terminated from his

¹⁴⁵ *Keller v. Commissioner*, 62 T.C.M. (CCH) 401 (1991).

¹⁴⁶ *Id.* at 402.

¹⁴⁷ *Id.* at 403-04.

¹⁴⁸ *Redfield v. Insurance Co. of N. Am.*, 940 F.2d 542, 548 (9th Cir. 1990).

¹⁴⁹ *Id.* at 544.

¹⁵⁰ *Id.*

¹⁵¹ *Id.*

¹⁵² *See id.*

¹⁵³ *Id.*

¹⁵⁴ *Id.* at 545.

¹⁵⁵ *Id.* at 547.

¹⁵⁶ *Id.*

¹⁵⁷ *Id.* at 549.

¹⁵⁸ *Sparrow v. Commissioner*, 949 F.2d 434, 434-35 (D.C. Cir. 1992).

position as a computer systems analyst with the Navy in February 1977.¹⁵⁹ He filed complaints for reinstatement, back pay, and other relief with the EEOC which ordered his reinstatement in January 1980.¹⁶⁰ The Navy did not reinstate Sparrow, and Sparrow filed suit in the District Court for the District of Columbia in September 1982.¹⁶¹ A settlement was reached which provided for payment of (1) \$69,000 with respect to his claim for reinstatement for the period of January 1980 through October 1982 and (2) \$23,000 for all other claims.¹⁶² The settlement agreement referred to Sparrow's release of all claims including any arising under Title VII.¹⁶³ The IRS argued that all of the payments were wage related and were not excludable under § 104(a)(2).¹⁶⁴ This argument is consistent with the Service's position in the age and sex discrimination cases discussed earlier.¹⁶⁵ Sparrow argued that the payments were damages for personal injury resulting from racial discrimination rather than wage payments.¹⁶⁶ The Tax Court held that Sparrow was precluded from bringing a tort action for damages due to sovereign immunity, and Sparrow, in fact, had no basis for suit against the U. S. government except under Title VII.¹⁶⁷ Title VII contains a provision which allows victims of covered discrimination to bring suit against the federal government.¹⁶⁸ Since Title VII only provides for payment of wage-related damages and prohibits awards of compensatory and punitive damages, the Tax Court held that none of the payments were excludable.¹⁶⁹

On appeal, the District of Columbia Circuit Court affirmed the Tax Court's decision in *Sparrow*.¹⁷⁰ The Circuit Court stated that two conditions must be met before an exclusion is allowable "... (1) the amount received must be damages and (2) the amount received as damages must result from a personal injury or sickness."¹⁷¹ The court did not provide a definition of damages but stated: "the term 'damages' as used in § 104(a)(2) embodies a monetary amount originally awarded at law, not in equity."¹⁷² The court analyzed the remedies of Title VII and concluded that back pay was an equitable remedy—not a legal remedy.¹⁷³ Since the court decided that Sparrow had not recovered damages, the issue of whether racial discrimination is a personal injury was moot. The

¹⁵⁹ *Id.* at 434.

¹⁶⁰ *Sparrow v. Commissioner*, 57 T.C.M. (CCH) 816, 817 (1989).

¹⁶¹ *Id.*

¹⁶² *Id.* at 818.

¹⁶³ *Id.*

¹⁶⁴ *Id.*

¹⁶⁵ *See, e.g.*, *United States v. Burke*, 112 S. Ct. 1867 (1992); *Metzger v. Commissioner*, 845 F.2d 1013 (3d Cir. 1988).

¹⁶⁶ *See Sparrow*, 57 T.C.M. (CCH) at 818.

¹⁶⁷ *Id.* at 819.

¹⁶⁸ *See* 42 U.S.C. § 2000e (1992).

¹⁶⁹ *Sparrow*, 57 T.C.M. (CCH) at 820.

¹⁷⁰ *Sparrow v. Commissioner*, 949 F.2d 434 (D.C. Cir. 1992).

¹⁷¹ *Id.* at 436.

¹⁷² *Id.* at 437.

¹⁷³ *Id.* at 437-38.

Circuit Court held that recovery of back pay under a Title VII claim was not excludable under § 104(a)(2) because it did not constitute "damages."¹⁷⁴

In *Stocks v. Commissioner*,¹⁷⁵ the Tax Court held that racial discrimination is a tort-like injury and that damages recovered on account of racial discrimination are excludable.¹⁷⁶ Stocks was a tenured professor at Sinclair Community College (College S).¹⁷⁷ Officials at College S decided that Stocks' performance was unsatisfactory and they would not extend her contract for the 1984-85 school year.¹⁷⁸ The regulations of College S required that a faculty member be given notice as of February first of the contract period, if a contract for the next school year would not be extended.¹⁷⁹ College S did not give timely notice of its intention to terminate employment of Stocks.¹⁸⁰ Sometime after August 1984 Stocks was informed that her contract would not be renewed for the 1984-85 school year.¹⁸¹ Stocks had previously filed racial discrimination charges against College S with the Ohio Civil Rights Commission and the U.S. Equal Opportunity Employment Commission.¹⁸² Prior to the filing of any lawsuits, Stocks proposed a settlement with College S which requested, among other actions, payment of salary and fringe benefits for year 1984-85 and attorney fees.¹⁸³ A settlement agreement was reached in November 1984 in which Stocks released all claims against College S and accepted \$24,000 in settlement.¹⁸⁴ The settlement agreement did not specify the nature of the settled claims.¹⁸⁵ College S representatives testified that \$24,000 was approximately the amount that would have been paid to Stocks for salary and fringe benefits for year 1984-85.¹⁸⁶ After reviewing the evidence the Tax Court found that two separate claims had been settled: (1) a breach of contract claim for failing to offer a contract for year 1984-85 and (2) a racial discrimination claim.¹⁸⁷ Since the settlement agreement made no allocation between the claims, the Tax Court was forced to do so and held that \$20,000 was received for breach of contract and \$4000 was received on account of racial discrimination.¹⁸⁸ The Tax Court held that the amount received for breach of contract

¹⁷⁴ *Id.* at 441.

¹⁷⁵ *Stocks v. Commissioner*, 98 T.C. 1 (1992).

¹⁷⁶ *Id.* at 10.

¹⁷⁷ *Id.* at 2.

¹⁷⁸ *Id.* at 4-5.

¹⁷⁹ *Id.* at 5.

¹⁸⁰ *Id.*

¹⁸¹ *Id.*

¹⁸² *Id.* at 3-4.

¹⁸³ *Id.* at 6.

¹⁸⁴ *Id.* at 6-7.

¹⁸⁵ *Id.*

¹⁸⁶ *Id.* at 11-12.

¹⁸⁷ *Id.* at 13.

¹⁸⁸ *Id.* at 17.

was not excludable.¹⁸⁹ The court held that racial discrimination is a personal injury and that damages received on account of racial discrimination are excludable.¹⁹⁰

Treatment of Punitive Damages

Section 104(a)(2) provides for the exclusion of "any damages received . . . on account of personal injuries or sickness."¹⁹¹ However, both the IRS and the courts have vacillated in their positions on the excludability of punitive damages. The current position of the IRS is that all punitive damages are taxable.

The 1989 RRA provided a partial victory for the IRS in the area of punitive damages by amending § 104(a)(2) to provide that "Paragraph (2) shall not apply to any punitive damages in connection with a case not involving physical injury or physical sickness."¹⁹² The scant legislative history of the 1989 RRA does not provide any indication of Congress' intent regarding the excludability of punitive damages in cases involving physical injury.¹⁹³ It is reasonable to assume that Congress intended to exclude punitive damages received in cases involving physical injury or sickness. This position has been rejected by the IRS. Congress could have provided that the exclusion does not apply to punitive damages regardless of the physical or nonphysical nature of the case. Whether it is proper to interpret Congressional intent based upon what Congress failed to do is debatable.

In *Revenue Ruling 58-418*, the taxpayer received a settlement in a libel suit for injury to his personal reputation.¹⁹⁴ The recovery included both compensatory and punitive damages.¹⁹⁵ The IRS ruled that the compensatory portion of the recovery was excludable from gross income and the punitive portion was not excludable.¹⁹⁶ The ruling cited *Glenshaw Glass Co.* as authority for including punitive damages in gross income.¹⁹⁷ No mention was made of either § 61 or § 104(a)(2).¹⁹⁸ In 1955, the Supreme Court held in *Glenshaw Glass Co.* that punitive damages received in an action for violation of Federal antitrust laws and fraud constituted gross income.¹⁹⁹ However, *Glenshaw* involved the issue of "includability" of punitive damages as part of gross income; exclusion as per-

¹⁸⁹ *Id.*

¹⁹⁰ *Id.*

¹⁹¹ I.R.C. § 104(a)(2) (1992).

¹⁹² Omnibus Reconciliation Act of 1989, Pub. L. No. 101-239, § 7641, 103 Stat. 2379, *reprinted in* 1989 U.S.C.A.N. (1989).

¹⁹³ *See* H.R. Rep. No. 101-247, 101st Cong., 1st Sess. 3 (1989).

¹⁹⁴ Rev. Rul. 58-418, 1958-2 C.B. 18.

¹⁹⁵ *Id.*

¹⁹⁶ *Id.* at 19-20.

¹⁹⁷ *Id.* at 19.

¹⁹⁸ *Id.* at 18-20.

¹⁹⁹ *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426, 432 (1955).

sonal injury damages was not at issue.²⁰⁰ Use of the principle announced in *Glenshaw* in a personal injury exclusion context is misplaced.

In *Revenue Ruling 75-45*, the IRS stated that "any damages, whether compensatory or punitive, received on account of personal injuries or sickness are excludable from gross income."²⁰¹ The IRS cited the gross income exclusion in § 104(a)(2) and emphasized the words "any" and "on account of."²⁰² Citing no other authorities, the IRS concluded that punitive damages were excludable under § 104(a)(2).²⁰³ In *Church v. Commissioner*, the Tax Court cited RR 75-45 with approval and held that both compensatory and punitive damages were received on account of personal injuries and were excludable under § 104(a)(2).²⁰⁴ In *Roemer*, the Ninth Circuit also cited RR 75-45 with approval and held that punitive damages, as well as compensatory damages, recovered by the taxpayer were excludable under § 104(a)(2).²⁰⁵

In *Revenue Ruling 84-108*, the IRS revoked RR 75-45 and held that punitive damages are includable in gross income.²⁰⁶ RR 84-108 covers two factual situations.²⁰⁷ In the first situation, the decedent died as a result of an aircraft accident in his employer's airplane.²⁰⁸ The employer's liability insurance policy provided for payments of certain sums to the decedent's survivors in release of claims under the decedent's state (Virginia) Wrongful Death Act.²⁰⁹ Under the Virginia Wrongful Death Act, no punitive damages were recoverable; only compensatory damages for actual losses of the survivors were recoverable.²¹⁰ In the second situation, the facts were the same except that the decedent's residence was Alabama.²¹¹ The Alabama wrongful death act provided for recovery of punitive damages only.²¹²

The IRS stated that the treatment of damages received in settlement of a claim under a wrongful death statute depended upon the characterization of the damages under applicable state law.²¹³ Damages received in the first situation (where the state Wrongful Death Act provided for compensatory damages only) were excludable from gross in-

²⁰⁰ *Id.* at 427.

²⁰¹ Rev. Rul. 75-45, 1975-1 C.B. 47.

²⁰² *Id.*

²⁰³ *Id.*

²⁰⁴ *Church v. Commissioner*, 80 T.C. 1104, 1110 n.7 (1983).

²⁰⁵ *Roemer v. Commissioner*, 716 F.2d 693, 700 (9th Cir. 1983).

²⁰⁶ Rev. Rul. 84-108, 1984-2 C.B. 32, 34.

²⁰⁷ *Id.* at 33.

²⁰⁸ *Id.*

²⁰⁹ *Id.*

²¹⁰ *Id.*

²¹¹ Rev. Rul. 84-108, 1984-2 C.B. 32, 33.

²¹² *Id.*

²¹³ *Id.*

come under § 104(a)(2).²¹⁴ Damages received in the second situation (where the state Wrongful Death Act provided for punitive damages only), on the other hand, were not excludable under § 104(a)(2).²¹⁵

In *Revenue Ruling 85-98*, the IRS restated the position adopted in RR 84-108.²¹⁶ The taxpayer's complaint asked for compensatory and punitive damages.²¹⁷ The IRS ruled that the actual damages received should be allocated between compensatory and punitive in the same ratio as the amounts of compensatory and punitive damages asked for in the complaint bore to the total damages.²¹⁸ The IRS ruled that the compensatory damages were excludable but that punitive damages were not excludable under § 104(a)(2).²¹⁹

At least one court has rejected the IRS's position on punitive damages espoused in RR 84-108 and 85-98. In *Burford v. United States*, a District Court in Alabama discussed RR 84-108 because it was squarely on point with the facts at hand.²²⁰ The Alabama Wrongful Death Act had been interpreted to provide exclusively for punitive damages, and the IRS had ruled that a recovery of damages under the Alabama act was not excludable under § 104(a)(2) because such recovery represented punitive damages.²²¹ The District Court rejected the IRS's ruling and held that a wrongful death action is a personal action and that any damages received (whether compensatory or punitive) are excludable.²²²

In *Miller*, the IRS argued that punitive damages received in settlement of a defamation action were not excludable under § 104(a)(2).²²³ The situation in *Miller* involved a non-physical injury (defamation) which occurred prior to the effective date of the RRA of 1989 amendments to § 104(a)(2).²²⁴ The Tax Court interpreted the adjective "any" preceding the word "damages" in § 104(a)(2) to mean "all."²²⁵ The Tax Court noted that the IRS had previously taken the position that punitive damages were excludable in RR 75-45.²²⁶ The Tax Court disagreed with the IRS's reversal of RR 75-45 and noted with approval the district court decision in *Burford*.²²⁷

²¹⁴ *Id.* at 34.

²¹⁵ *Id.*

²¹⁶ See Rev. Rul. 85-98, 1985-2 C.B. 51.

²¹⁷ *Id.*

²¹⁸ *Id.* at 52.

²¹⁹ *Id.*

²²⁰ *Burford v. United States*, 642 F. Supp. 635, 637 (N.D. Ala. 1986).

²²¹ *Id.*

²²² *Id.* at 638.

²²³ *Commissioner v. Miller*, 914 F.2d 586, 587 (4th Cir. 1990).

²²⁴ See *id.*

²²⁵ *Commissioner v. Miller*, 93 T.C. 330, 338 (1989), *rev'd*, 914 F.2d 586 (4th Cir. 1990).

²²⁶ *Id.* at 339.

²²⁷ *Id.*

On appeal to the Fourth Circuit, the IRS conceded that the amendment to § 104(a)(2) regarding punitive damages enacted by RRA 1989 did not apply to *Miller*.²²⁸ Even so, the IRS argued that punitive damages are not intended to compensate the plaintiff for personal injury and result in a 'windfall' to the plaintiff by providing a recovery in excess of compensatory damages.²²⁹ It is clear that the IRS's position is that punitive damages received in any personal injury (physical or nonphysical) are not excludable. The Fourth Circuit noted that punitive damages are awarded to punish the defendant rather than compensate the plaintiff.²³⁰ The court stated that punitive damages were not paid "on account of" personal injury because something more than a personal injury is required to warrant the awarding of punitive damages.²³¹ The plaintiff must show malicious, unjustifiable conduct by the defendant.²³² Following the judicially developed doctrine of narrow construction of exclusions of income, the Circuit Court held that punitive damages are not "compensation" for injuries and thus are not within the scope of the § 104(a)(2) exclusion.²³³

In *Kemp v. Commissioner*, a U.S. District Court held that punitive damages are not excludable under § 104(a)(2).²³⁴ Kemp recovered punitive damages in a civil rights action under 42 U.S.C. § 1983.²³⁵ The District Court found that punitive damages recovered under § 1983 do not compensate plaintiffs for civil rights violations.²³⁶ The court agreed with the Fourth Circuit's decision in *Miller* that punitive damages constitute a "windfall" and are outside the scope of § 104(a)(2).²³⁷

Tax Planning Implications

1. Injury to Reputation

Taxpayers have prevailed on the issue of excludability of recoveries for injury to reputation in the Ninth Circuit in *Roemer*²³⁸ the Sixth Circuit in *Threlkeld*²³⁹ and the Tax Court in *Miller*.²⁴⁰ However, the IRS has not acquiesced in any of these decisions. Therefore, taxpayers should consider the potential for disagreement with the IRS in planning for the tax consequences of such recoveries. The following suggestions are

²²⁸ *Miller*, 914 F.2d at 588 n.4.

²²⁹ *Id.* at 591.

²³⁰ *Id.*

²³¹ *Id.*

²³² *Id.*

²³³ *Id.* at 590.

²³⁴ *Kemp v. Commissioner*, 771 F. Supp. 357, 359 (S.D. Ga. 1991).

²³⁵ *Id.* at 358.

²³⁶ *Id.* at 359.

²³⁷ *Id.*

²³⁸ See *Roemer v. Commissioner*, 716 F.2d 693 (9th Cir. 1983).

²³⁹ See *Threlkeld v. Commissioner*, 848 F.2d 81 (6th Cir. 1988).

intended to reduce the area of conflict and the likelihood of an IRS attack on recoveries for injury to professional reputation.

First, the taxpayer should choose his remedy, if possible, under a cause of action which has been characterized as a personal cause of action under state law. The Tax Court in *Miller* reviewed state law to determine the nature of the cause of action and found that the taxpayer's action for defamation was an action for personal injuries and held that the recovery was excludable.²⁴¹

Second, the complaint should specify the nature of all claims and identify the personal nature, where appropriate, of each. The Tax Court in *Threlkeld* stated that the issue of whether the claim was on account of "personal injuries" depends on the nature of the claim.²⁴² The Tax Court noted that reliance on state law alone, was not sufficient in all cases to determine the nature of the injury.²⁴³ This would be very important in a case where multiple claims are presented in one cause of action.

Third, if a settlement is reached, the agreement should allocate the damage award to the various claims. This allocation should reduce the likelihood of an IRS argument that all damages were received on account of injury to professional reputation.

Fourth, if an action is concluded in court, the plaintiff should request that the court or jury allocate the damage award to the various claims on which the plaintiff prevailed. However, the plaintiff should consider the possibility of an unfavorable allocation before making this request. Since an IRS attack is probable, the taxpayer must choose his strategy carefully.

2. Discrimination

Generally, victims of age, sex, or race discrimination will bring suit under the ADEA, EPA, and/or Title VII of the Civil Rights Act. Since all of these statutes provide for wage-related payments, the IRS will challenge the excludability of at least a portion of the payments.²⁴⁴ Even though taxpayers have successfully challenged the position of the IRS in recent cases, the IRS has not retreated from its position.²⁴⁵

To reduce the amount of challengeable exclusions, taxpayers should consider the following suggestions. First, the complaint filed in a discrimination suit should emphasize causes of action which are tort or tort-type under state law. The plaintiff should

²⁴⁰ See *Miller v. Commissioner*, 914 F.2d 586 (4th Cir. 1990).

²⁴¹ *Miller v. Commissioner*, 93 T.C. 330 (1989), *rev'd*, 914 F.2d 586 (4th Cir. 1990).

²⁴² *Threlkeld v. Commissioner*, 87 T.C. 1294 (1986), *aff'd*, 848 F.2d 81 (6th Cir. 1988).

²⁴³ *Id.*

²⁴⁴ See, e.g., *United States v. Burke*, 112 S. Ct. 1867(1992); *Metzger v. Commissioner*, 845 F.2d 1013 (3rd Cir. 1988).

²⁴⁵ See, e.g., *Burke*, 112 S.Ct. at 1867; *Metzger*, 845 F.2d at 1013.

present evidence in negotiations or at the trial of his or her injury and explain its relationship to the tort or tort-type claims. Second, the plaintiff should allocate any settlement recovery to the various claims and should specifically allocate as much as reasonably possible to non-wage claims. Third, if judgment is awarded at the completion of a suit, the plaintiff should ask the court to allocate the recovery between wage-related payments and other payments. It is unlikely that the IRS will successfully challenge a court allocation. However, the plaintiff should consider the likelihood of an unfavorable allocation before requesting an allocation.

3. Punitive Damages

The 1989 RRA eliminated the exclusion for punitive damages in cases not involving physical injury or sickness.²⁴⁶ In cases involving physical injury or sickness, the IRS's position on punitive damages is clear: punitive damages are taxable even if received in the context of a physical injury suit or settlement.²⁴⁷ Taxpayers should consider the impact of the recent amendment to § 104(a)(2) and the IRS's position on punitive damages before filing the complaint or negotiating a settlement in a personal injury action. The following tax planning ideas should be considered.

First, carefully weigh the tax cost of seeking punitive damages in any action against the potential benefits to be obtained in terms of negotiating a settlement or obtaining a favorable judgment. No general rules can be established in this regard since the decision to seek punitive damages will be based upon such considerations as the type of action, remedies available, the nature of the defendant's conduct, and the strength of the plaintiff's position. However, the taxpayer's counsel must be aware of the tax implications of punitive damages.

Second, any settlement agreement should specifically provide for the acceptance of compensatory damages only. The IRS may challenge a settlement agreement which provides solely for compensatory damages when the complaint asks for punitive damages. The IRS may apply the method of allocation described in RR 85-98 to the settlement agreement.²⁴⁸ The plaintiff should be prepared to substantiate the compensatory damages and explain the omission of punitive damages.

Third, the plaintiff may request that damages awarded by the court or jury be specifically allocated between compensatory and punitive portions. It is unlikely that the IRS would challenge such an allocation.

²⁴⁶ Omnibus Reconciliation Act of 1989, Pub. L. No. 101-239, § 7641, 103 Stat. 2379, reprinted in 1989 U.S.C.A.N. (1989).

²⁴⁷ See, e.g., *Threlkeld*, 848 F.2d at 81; *Downey v. Commissioner*, 97 T.C. 150 (1991).

²⁴⁸ Rev. Rul. 85-98, 1985-2 C.B. 51.

CONCLUSION

Taxpayers can take comfort in the positions of the Tax Court and the Third, Sixth, and Ninth Circuits regarding the excludability of recoveries for injury in defamation and age discrimination suits. However, litigation with the IRS is almost assured in spite of prior taxpayers' successes in these areas. The ruling of the Supreme Court in *Burke* appears to be a narrow ruling which may have no impact on Title VII cases brought under amended Title VII. However, it could have a significant impact in other areas of discrimination. The Supreme Court held that wage-related damages recovered by Burke in the sex discrimination suit were not excludable. This ruling seemed to rely on the conclusion that pre-1991 Title VII provided for no traditional tort remedies.²⁴⁹ In contrast the ADEA provides for back pay and traditional tort remedies (i.e., compensatory and punitive damages) for victims of age discrimination.²⁵⁰

The IRS probably will continue to challenge the exclusion of back pay received in discrimination suits. It is possible that the Supreme Court will have an opportunity to address this issue unless Congress acts to clear this area of contention between the IRS and taxpayers. Due to the potential for future contests with the IRS, taxpayers must give careful consideration to remedies chosen, evidence presented, and wording of settlement agreements.

The 1989 RRA amended § 104(a)(2) to prohibit the exclusion of punitive damages in cases not involving physical injury or sickness.²⁵¹ Despite the inconsistencies in its position on the taxation of punitive damages and the implications of recent amendments to § 104(a)(2), the IRS has given no indication of a willingness to change its position. The taxpayer is best advised to plan carefully to avoid the receipt of punitive damages.

Careful planning is required to reduce the potential for conflict with the IRS in discrimination and defamation suits. The taxpayer is well advised to consider the tax implications of his or her claims against the defendant before a complaint is filed. Otherwise, the taxpayer's recovery, net of taxes, may be much less than originally anticipated. The tax planning suggestions described in this article should reduce the likelihood of an unexpected tax liability.

²⁴⁹ See *United States v. Burke*, 112 S.Ct. 1867, 1874 (1992).

²⁵⁰ See 29 U.S.C. §§ 623-631 (1992).

²⁵¹ See I.R.C. § 104 (a)(2) (1992).